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TAGS: EFIN, EGEN, ECON, UK

SUBJECT: NIESR FORECAST GENERATES CONTROVERSY

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SUMMARY: THE FINAL 1976 QUARTERLY ECONOMIC REVIEW OF THE

NATIONAL INSTITUTE FOR ECONOMIC AND SOCIAL RESEARCH (NIESR) HAS ATTRACTED MORE THAN THE USUAL SHARE OF ATTENTION BECAUSE OF A CONTROVERSIAL ESTIMATE OF NEXT YEAR'S PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) AND A FORECAST OF AN OVERALL CURRENT ACCOUNT SURPLUS IN 1977. NIESR EXPECTS SLOWER REAL GROWTH (1.7 PERCENT) AND HIGH UNEMPLOYMENT (1.3 MILLION) COUPLED WITH A RAPID RISE IN THE CONTRIBUTION OF NORTH SEA OIL TO THE CURRENT ACCOUNT. THEIR ESTIMATES REPRESENT A SCALING DOWN BY NEARLY HALF IN THE FORECAST RATE OF GROWTH IN 1977 MADE IN THE AUGUST NIESR FORECAST. END SUMMARY.

1. PUBLISHED DURING A PERIOD OF INTENSIVE NEGOTIATIONS BETWEEN HMG AND THE IMF TEAM, NIESR'S FINAL QUARTERLY ECONOMIC REVIEW LENT SUPPORT TO THOSE WITHIN THE CABINET ARGUING AGAINST FURTHER LARGE CUTS IN PUBLIC EXPENDITURE BY ESTIMATING THAT THE FY 77 PUBLIC SECTOR BORROWING REQUIREMENT WOULD BE IN THE RANGE OF 8 TO 8.5 BILLION POUNDS COMPARED WITH HMTREASURY'S REPORTED FIGURE OF 10.5 - 11.0 BILLION POUNDS. BEFORE DISCUSSING THE BASIS FOR THIS ESTIMATE, IT IS NECESSARY TO SET OUT NIESR'S BASIC ECONOMIC ASSUMPTIONS AND A GENERAL OUTLINE OF ITS FORECAST.

2. ECONOMIC ASSUMPTIONS. WORLD TRADE GROWTH IS EXPECTED TO AVERAGE 8 PERCENT IN 1977 AND 6 TO 7 PERCENT IN 1978 WITH AVERAGE CONSUMER PRICES IN OECD COUNTRIES RISING BY ABOUT 8 PERCENT IN 1977. FOR BRITAIN, NIESR ASSUMES UNCHANGED GOVERNMENT POLICIES COUPLED WITH ABNORMALLY LOW GROWTH IN PRODUCTIVITY BECAUSE OF GOVERNMENT EFFORTS TO SPREAD WORK. MONEY SUPPLY GROWTH (M3) IS ASSUMED TO DECLINE SLOWLY TO 10 PERCENT AT AN ANNUAL RATE BY THE END OF 1978. AVERAGE EARNINGS ARE ASSUMED TO RISE BY 9 PERCENT IN THE YEAR THROUGH AUGUST 1977 INCREASING TO 12 PERCENT THROUGH 1978. FINALLY THE BRITISH APPLICATION TO THE IMF IS ASSUMED TO BE SUCCESSFUL AND SOME NEGOTIATED ARRANGEMENT ON STERLING BALANCES IS EXPECTED.

ON THESE ASSUMPTIONS, THE NIESR FORECAST IS SUMMARIZED IN THE FOLLOWING TABLE:

UNEMPLOYMENT M3 CONSUMER
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REAL GDP	4TH QUARTER	P/C CHANGE	PRICES
P/C CHANGE	MILLIONS	END-YEAR	P/C CHANGE
1976	1.0	1.3	11.8 15.5
1977	1.7	WQME	11.0 13.2
1978	WPMW	1.5	10.1 8.5
PUBLIC			
REAL	SECTOR		
PERSONAL	CURRENT		BORROWING

	DISPOSABLE	ACCOUNT	EXCHANGE	REQUIREMENT
	INCOME	(BILLIONS	RATE 4TH	(BILLIONS
	P/C CHANGE	OF POUNDS)	QUARTER	OF POUNDS)
1976	-1.2	-1.7	\$1.65	10.4
1977	-1.9	1.1	\$L.68	8.2
1978	1.4	5.0	\$1.80	6.0

3. REAL GDP WILL GROW MORE SLOWLY IN 1977 THAN ANTICIPATED IN EARLIER NIESR FORECASTS. THIS IS DUE TO THE RECENT SHARP DOP IN STELING WHICH REDUCES REAL INCOMES, LEADS TO HIGHER INTEREST RATES, AND REDUCES THE LEVEL OF INVESTMENT. REAL CONSUMER EXPENDITURE SHOULD DECLINE BY

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0.4 PERCENT IN 1977. THIS IS LESS THAN THE 1.9 PERCENT DECLINE IN REAL DISPOSABLE INCOME SINCE NIESR BELIEVES THAT SALES OF DURABLES WILL EXHIBIT SOME FIRMNESS AS CONSUMERS PURCHASE AUTOMOBILES, REFRIGERATORS, ETC. AS A HEDGE AGAINST INFLATION. THE SAVINGS RATIO WILL DROP FROM 13.1 IN 1976 TO 11.7 IN 1977.

4. INVESTMENT WILL BE SPOTTY IN 1977. HIGH INTEREST RATES ARE EXPECTED TO CONTRIBUTE TO A DECLINE OF 7.6 PERCENT IN LIMITED OFFICIAL USE

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CENT IN HOUSING INVESTMENT, PUBLIC AND PRIVATE. OTHER FORMS OF PUBLIC SECTOR INVESTMENT WILL DROP BY 9.3 PERCENT. THE ONLY BRIGHT SPOT IS A 10.1 PERCENT RISE IN MANUFACTURING INVESTMENT. OVERALL INVESTMENT WILL SHOW A DECLINE OF 2.2 PERCENT IN 1977. INVENTORY GROWTH SHOULD RESUME IN 1977 BUT WILL BE RESTRICTED BY THE HIGH LEVEL OF INTEREST RATES.

5. EXPORT VOLUME IS EXPECTED TO RISE BY 6.3 PERCENT IN 1977. THIS IS A FIGURE WHICH IS GENERATED BY THE ASSUMPTION ON WORLD TRADE GROWTH AND AN ASSUMED ELASTICITY OF ABOUT 0.8 RELATING GROWTH IN UK EXPORTS TO GROWTH IN WORLD TRADE. THE RISE IN THE VOLUME OF IMPORTS IS PUT AT 2.3 PERCENT FOR 1977, A CONSIDERABLE DROP FROM THE ESTIMATED 1976 FIGURE OF 6.6 PERCENT. THIS RESTRAINED PERFORMANCE IS DUE TO INCREASED COMPETITIVENESS OF IMPORT SUBSTITUTES, RAPIDLY RISING NORTH SEA OIL OUTPUT (44 MILLION TONS) AND SLOWER GROWTH IN GDP. TRANSLATING VOLUME FIGURES INTO CURRENT ACCOUNT TERMS, NIESR EXPECTS THE VALUE OF EXPORTS OF GOODS AND SERVICES TO RISE BY 24.1 PERCENT WHILE THE VALUE OF IMPORTS OF GOODS AND SERVICES RISES BY 14.6 PERCENT. THIS RESULTS IN A VISIBLE TRADE DEFICIT OF 1.087 BILLION POUNDS COMPARED WITH A FORECAST OF 3.536 BILLION POUND DEFICIT IN 1976. WHEN COUPLED WITH A SURPLUS OF 2.202 BILLION POUNDS ON INVISIBLES, THE CURRENT ACCOUNT MOVES INTO A SURPLUS OF 1.115 BILLION POUNDS COMPARED WITH A LIKELY 1976 DEFICIT OF 1.8 BILLION.

6. THE MASSIVE CURRENT ACCOUNT TURNAROUND IS DUE IN LARGE PART TO NORTH SEA OIL WHOSE NET CONTRIBUTION IS PUT AT 2.814 BILLION POUNDS FOR 1977. IT ACCOUNTS FOR ABOUT 2/5 OF THE 10 PERCENT IMPROVEMENT IN THE TERMS OF TRADE EXPECTED BY NIESR WITH THE REMAINDER ATTRIBUTED TO A MORE STABLE POUND AND A SHARP SLOWDOWN IN THE RATE OF INCREASE

IN WORLD COMMODITY PRICES TO ABOUT 1.5 PERCENT. NIESR PUTS THE TRADE-WEIGHTED DEPRECIATION OF STERLING FOR 1977 AT 39.3 PERCENT INDICATING A BELIEF THAT STERLING MAY STRENGTHEN BY NEARLY 10 PERCENT FROM ITS PRESENT LEVEL. NIESR WARNS OF THE HAZARDOUS NATURE OF THE CURRENT ACCOUNT FORECAST AND ADMITS THAT ITS TIMING COULD WELL BE WRONG, BUT NEVERTHELESS BELIEVES IT A STRONG PROBABILITY THAT LIMITED OFFICIAL USE

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THE CURRENT ACCOUNT WILL MOVE INTO SURPLUS SOME TIME IN 1977.

7. THE MOST CONTROVERSIAL ASPECT OF THE NIESR FORECAST IS ITS ESTIMATE THAT THE FY 1977 PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) WILL BE 8.2 BILLION POUNDS. THIS FIGURE IS OBTAINED AS A RESULT OF HIGHER REVENUES DUE TO FISCAL DRAG. INFLATION IS PUT AT 13.2 PERCENT IN 1977 COMPARED WITH 12.7 PERCENT IN NIESR'S AUGUST FORECAST. LESS RAPID EXPENDITURE GROWTH IS ANTICIPATED BECAUSE OF THE SUCCESSFUL APPLICATION OF CASH LIMITS. GOVERNMENT OUTLAYS ARE FURTHER CONSTRAINED BY NIESR'S ASSUMPTION THAT PUBLIC SECTOR WAGES WILL GROW MORE SLOWLY THAN PRIVATE SECTOR WAGES. GIVEN THE LOWER PSBR, TO STAY WITHIN ITS M3 TARGET RATE, HMG WILL HAVE TO SELL 3.75 BILLION POUNDS IN GILTS TO THE NON-BANK PUBLIC. INTEREST RATES ON CONSOLS (LONG-TERM BONDS) ARE EXPECTED TO DECLINE SLIGHTLY TO ABOUT 15 PERCENT BY THE END OF 1977.

8. REALIZING THAT FORECASTING ON THE BASIS OF UNCHANGED GOVERNMENT POLICY IS A DANGEROUS OCCUPATION, NIESR ALSO PROVIDES 4 ALTERNATIVE FORECASTS. THESE ARE BASED ON

- HIGHER PRODUCTIVITY GROWTH
- A CONSTANT EXCHANGE RATE (\$1.63)
- SPENDING CUTS OF 2 BILLION POUNDS IN FY 77
- INDIRECT TAX INCREASES OF 2 BILLION POUNDS IN FY 77

THESE ALTERNATIVES HAVE PREDICTABLE EFFECTS ON GROWTH, INFLATION, EMPLOYMENT, THE CURRENT ACCOUNT AND THE EXCHANGE RATE. FOR EXAMPLE, THE SPENDING CUT ALTERNATIVE REDUCES 1977 GROWTH TO 0.8 PERCENT, INCREASES UNEMPLOYMENT BY 0.1 MILLION, INCREASES THE CURRENT ACCOUNT SURPLUS TO 1.4 BILLION POUNDS AND REDUCES THE PSBR TO 7.0 BILLION POUNDS. THE INDIRECT TAX INCREASES RAISES PRICES BY ONE PERCENTAGE POINT AND REDUCES THE GROWTH RATE FROM 1.7 TO 1.4 PER

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CENT. THESE ALTERNATIVES HELP TO EXPLAIN WHY NIESR
STRONGLY OPPOSES FURTHER RESTRICTIVE MEASURES.

9. IN ITS APPRAISAL STATEMENT NIESR CALLS ON GERMANY
AND JAPAN TO REDUCE THEIR PAYMENTS SURPLUSES TO EASE
PRESSURE ON INDUSTRIAL DEFICIT COUNTRIES. OPPOSITION TO
FURTHER DEFLATION IS EXPLAINED BY THE ABSENCE OF ANY AU-
TOMATIC PROCESS BY WHICH THE PRIVATE SECTOR TAKES UP
QUICKLY, OR TO A SUFFICIENT EXTENT, RESOURCES FREED BY
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THE PUBLIC SECTOR WHEN THE ECONOMY IS BELOW FULL EMPLOYMENT. NIESR SUGGESTS THAT THE FLEXIBILITY NEEDED FOR THE NEXT PHASE OF WAGE RESTRAINT SHOULD BE ACHIEVED BY TAX REDUCTION RATHER THAN DIFFERENTIAL WAGE INCREASES.

10. COMMENT: NIESR ADMITS THAT THE PSBR IS A VERY HARD FIGURE TO FORECAST, REPRESENTING AS IT DOES THE RESIDUAL BETWEEN TWO VERY LARGE AGGREGATES. AS A RESULT, SMALL CHANGES IN PUBLIC REVENUES, EXPENDITURES OR BOTH HAVE LARGE IMPACTS ON THE ULTIMATE SIZE OF THE PSBR. NIESR'S ASSUMPTIONS OF STRICTLY ENFORCED CASH LIMITS ON EXPENDITURE COUPLED WITH SLOWER GROWTH IN PUBLIC SECTOR WAGES THAN IN THE PRIVATE SECTOR COULD PRODUCE A LOWER ESTIMATE THAN WOULD HM TREASURY. NEVERTHELESS, THE DIFFERENCE BETWEEN NIESR'S ESTIMATE OF REAL GROWTH IN 1977 (1.7 PERCENT) AND THAT OF HM TREASURY (2.5 PERCENT) WOULD ARGUE FOR A LARGER PSBR, GIVEN INCREASED UNEMPLOYMENT AND LOWER TAX REVENUES ASSOCIATED WITH THE LOWER ESTIMATE. MUCH ALSO DEPENDS ON THE LEVEL OF BORROWING BY LOCAL AUTHORITIES WHICH ACCOUNTS FOR ABOUT A FIFTH OF THE PSBR. ON THESE GROUNDS THE NIESR ESTIMATE APPEARS OVERLY OPTIMISTIC.

THE ALTERED FORECAST IN THE CURRENT ACCOUNT DERIVES FROM THE CHANGE IN NIESR'S ASSUMPTION THAT FOREIGN CURRENCY IMPORT PRICES WILL RISE BY 1.5 PERCENT RATHER THAN 10 PERCENT IN 1977, WHICH CHANGE ALONE IS WORTH A 3 BILLION POUND IMPROVEMENT IN THE CURRENT ACCOUNT. IMPROVEMENTS IN THE TERMS OF TRADE ON THE ORDER OF 10 PERCENT (1976 IV - 1977 IV) ARE BASED ON A PRICE INDICATOR CONSTRUCTED BY DIVIDING AN IMPORT VOLUME INDEX USING 1970 PRICE WEIGHTS INTO AN ESTIMATE OF CURRENT IMPORT VALUES. THUS, IT IS POSSIBLE TO HAVE MOVEMENT IN THE INDICATOR CAUSED BY VOLUME CHANGES ALONE. SINCE OIL PRICES IN 1970 WERE ABOUT 1/16 OF THEIR CURRENT LEVEL IN STERLING TERMS, A SMALL CHANGE IN OIL IMPORT VOLUME CAUSES A LARGE CHANGE IN OIL IMPORT VALUE. QUITE APART FROM NIESR'S QUESTIONABLE STATISTICAL METHODS, THE CURRENT ACCOUNT ESTIMATE COULD EASILY FOUNDER IF WORLD COMMODITY PRICES RESPOND TO STIMULATIVE ECONOMIC MEASURES, SHOULD THEY BE INTRODUCED IN THE US AND THE FRG. IT DOES SEEM LIKELY, HOWEVER, THAT BRITAIN'S CURRENT ACCOUNT WILL BE LIMITED OFFICIAL USE

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APPROACHING EQUILIBRIUM BY THE END OF 1977.

11. NIESR'S SUGGESTION THAT TAX REDUCTIONS BE USED AS A MEANS OF OVERCOMING SOME OF THE LABOR MARKET DISTORTIONS PRODUCED BY 2 YEARS OF RIGID INCOMES POLICY IS LIKELY TO STRIKE A RESPONSIVE CHORD. THE CHANCELLOR HAS ALREADY

BEGUN TO DROP HINTS THAT SUCH A POSSIBILITY IS UNDER
ACTIVE CONSIDERATION.

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